



CRIMEA SANCTIONS HIGHLIGHT COMPLIANCE RISK IN RUSSIAN ENERGY SECTOR

OVERVIEW

On May 12, 2014, the European Union added two Crimea-based energy firms to its Russia sanctions list: Chernomorneftegaz and Feodosia Enterprise (aka Feodosia Oil Product Supply Company or “Feodosia”). The sanctions were levied in response to the expropriation of the companies by the separatist Crimean government in March 2014. To date, the United States and Canada have sanctioned Chernomorneftegaz, but not Feodosia.

Both companies were previously controlled by the Ukrainian government and active in Ukraine’s emerging Black Sea oil and gas sector – Chernomorneftegaz in exploration and production, and Feodosia in shipment.

Following annexation, Russia announced plans to further integrate with the Crimean economy. To this end, Russian energy and transport companies may be expanding commercial ties with sanctioned entities or firms expropriated by the Crimean government. In some cases, these Russian companies have relied on foreign capital and joint ventures with foreign partners to expand capacity.

Global financial institutions and energy firms active in the region should be particularly sensitive to companies that are increasing their exposure to Crimea’s energy sector, as the EU and US have demonstrated a willingness to target strategic oil and gas interests implicated in the misappropriation of Ukrainian assets.



CHERNOMORNEFTEGAZ INVITES RUSSIAN ENGAGEMENT

Chernomorneftegaz is involved in offshore exploration and production of natural gas deposits in the Black Sea. In 2013, the company produced more than one billion cubic meters of gas. Following annexation, Russia's Energy Minister suggested that the firm would significantly increase its output in 2014.

Prior to the crisis, a number of major European oil and gas companies announced Black Sea exploration and production joint ventures with Chernomorneftegaz. The current status of those joint ventures with foreign partners is unclear.

- For example, in late 2013 Italy's ENI and France's Electricite de France reached an agreement with Chernomorneftegaz and Vody Ukrainy to explore 540 square miles off Crimea's east coast. In 2007 and 2009, Chernomorneftegaz signed joint exploration agreements with UK-registered CBM Oil and Shelton Petroleum of Sweden, respectively.
- In April, Russian and Crimean officials stated that foreign investors involved in exploration and production projects in offshore Crimean fields, previously approved by the Ukrainian government, must begin negotiations with Russian representatives. The owners of licenses for the shelf deposits would be required to re-register their licenses, in accordance with Russian legislation.

Following Russia's takeover of Crimea, but prior to the designation of Chernomorneftegaz by the US on April 11, the Crimean separatist government signaled that Russia oil and gas giant Gazprom could take control of Chernomorneftegaz.

- In mid-March 2014, a delegation of 11 Gazprom representatives visited Crimea and discussed the opening of a Gazprom office in Simferopol "possibly on the premises of Chernomorneftegaz."
- Immediately after Crimea's annexation, Chernomorneftegaz's deputy CEO announced that the company would become a Gazprom business unit, following its nationalization and the establishment of a new enterprise set up to receive all the licenses to develop the Black Sea shelf in Crimea.
- On April 9, the Crimean separatist government announced that it was ready to transfer its offshore Black Sea and Sea of Azov carbon deposits to Gazprom.



The current status of Gazprom's relationship with Chernomorneftegaz is unclear, although at least one media report speculates that the US sanctions on April 11 were intended to complicate a Gazprom takeover of Chernomorneftegaz.

- Even if Gazprom holds short of acquiring Chernomorneftegaz due to US, EU, and Canadian sanctions, the company could still facilitate Chernomorneftegaz's operations. For example, Gazprom could use third-party entities to purchase equipment for Chernomorneftegaz, according to one oil and gas analyst at a European bank.

Notwithstanding the US and EU designations, Chernomorneftegaz has signaled its intention to expand capacity and engage with regional banks.

- In May, Chernomorneftegaz announced plans to start construction on an LPG plant in the Crimean peninsula and to build a pipeline to the Krasnodar region of southern Russia, highlighting its need to access capital and materials.
- Chernomorneftegaz "works with" the Black Sea Bank for Development and Reconstruction and Moscow-based OAO Russian National Commercial Bank ("RNKB"), according to a Chernomorneftegaz spokesman on the day after the EU designation.

About Chernomorneftegaz: Prior to Russia's annexation of Crimea, Chernomorneftegaz developed Ukrainian deposits in the Black and Azov Seas. The company also produced hydrocarbons in the Crimean fields and ran the Hlibovske underground gas storage facility and the gas mains located on the peninsula. The company was fully owned by Naftogaz Ukraine, the country's state-owned gas company. *Source: Interfax-Ukraine.*

FEODOSIA DESIGNATION CREATES SANCTIONS RISK IN RUSSIAN ENERGY TRANSPORT

EU-designated Feodosia Enterprise operates a key shipping facility in Crimea for oil imports and exports. Prior to the crisis, Feodosia was one of Ukraine's primary transshipment terminals, capable of handling 12 million metric tons of petroleum products annually and transferring crude oil from ocean-going tankers on to freight trains.



- On March 25, the separatist Crimean parliament nationalized the company and decreed that the Crimean Ministry of Fuel and Energy would be the governing body of Feodosia.
- As of April 15, Crimea was “fully provided with fuel by supplies of Russia’s oil trading companies through the Feodosia-based petroleum storage and distribution centre,” according to Crimea’s separatist Minister of Fuel and Energy.

Major Russian transport firms and banks have been involved in shipments to Feodosia during the territorial crisis.

Prior to the EU designation of Feodosia, a subsidiary of UCL Holdings – Russia’s largest private transport company – made at least four oil tanker deliveries to Feodosia this year, according to Fleetmon’s ship tracking data.

- Three of the four UCL shipments to Feodosia were made after the terminal was overtaken by pro-Russian militia, but prior to the formal annexation of Crimea by Russia.
- The four shipments were made on three tanker vessels owned by the leasing arm of a Russian bank active in the transport and defense sectors, according to maritime databases.

About Feodosia Enterprise: According to the company’s website, Feodosia Enterprise provides oil transshipment services via rail and sea. The company’s capabilities include loading and unloading of oil tanker train cars and maritime vessels, oil pumping and storage, and laboratory testing of oil and motor fuels. Feodosia Enterprise operates a facility at the Feodosia port and maintains offices in the town of Feodosia.

NON-DESIGNATED CRIMEAN ENERGY FIRMS MAY PRESENT ADDITIONAL EXPOSURE

Other Crimea-based energy firms not under sanctions may also be controlled by recently sanctioned entities or under the influence of the new Crimean government. For example, on March 27 Crimea’s newly installed Deputy Minister of Fuel and Energy announced that JSC Krymgaz (“Krymgaz”) was negotiating with Russian companies on the delivery of liquefied petroleum gas, suggesting that Krymgaz is working closely with the Crimean government. To date, Krymgaz has not been designated by the US, Canada, or the EU.



- According to its website, Krymgaz supplies “natural and liquefied gas, operation of gas supply systems, gasification facilities, and other industrial, commercial, financial activities” and is engaged in “the development and implementation of current and future development plans of gas supply systems of the Republic of Crimea.”
- According to Ukrainian media reports as of 2013, Ukrainian energy tycoon Dmytro Firtash may own up to 23 percent of Krymgaz through the private joint stock company Gastek, a company often associated with Firtash. Chernomorneftegaz controlled 15.5 percent of Krymgaz as of 2013, according to Interfax.
- In March 2014, Firtash was arrested in Austria on US charges of foreign bribery. Firtash allegedly conspired to bribe Indian government officials to secure mining rights in India, according to the Department of Justice. Firtash is reported to control other major Crimea-based companies.

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